



King County Investment Pool

2004 Annual Report

King County

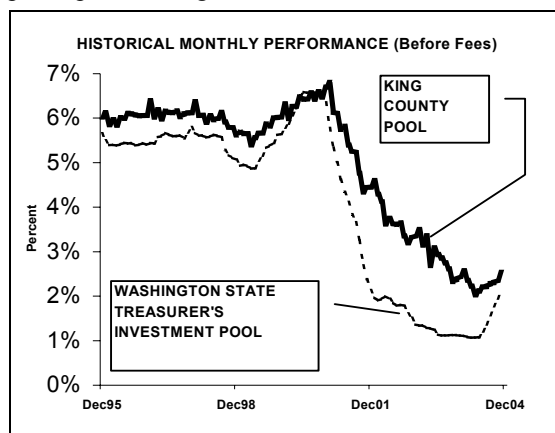
Finance & Business Operations Division

Pool Report Website: <http://www.metrokc.gov/finance//treasury/KCInvestmentPool2004.pdf>

"The average rate paid for the entire year was 2.3%, and the Pool distributed over \$78 million to all participants during 2004."

■ Pool Performance

The King County Investment Pool (the Pool) rate began the year at about 2.45%, but the combination of short-term market rates near 1% and the Pool's higher yielding securities maturing or being called, caused the Pool rate to trough in May at just over 2%. However, once the Federal Open Market Committee (FOMC) began to increase short-term rates in June, the Pool rate also started to climb, and by year-end the Pool was returning 2.54%. The average rate paid for the entire year was 2.3%, and the Pool distributed over \$78 million to all participants during 2004.

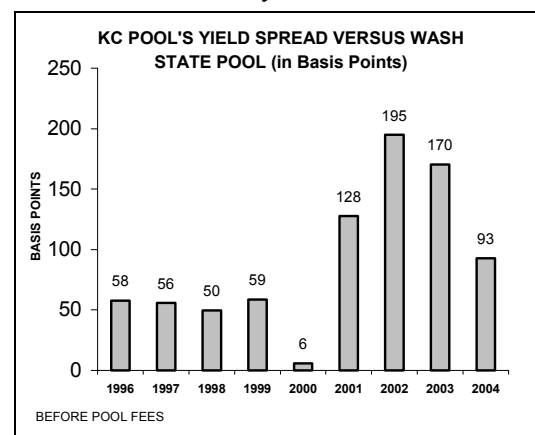


In prior years, the Pool Annual Report has compared the Pool's performance to the performance of King County districts that did not invest through the Pool. In November 2004, the last district still placing discrete investments joined the Pool. While the Pool is always pleased to add new members, this meant we lost one of the performance benchmarks that the Pool uses.

In this year's report the Pool's return will be compared to the return earned by the Local Government Investment Pool (LGIP) managed by the Washington State Treasurer's Office. There are three reasons why the LGIP was selected as the new performance benchmark. First, this is an investment option that local governments in the state can legally utilize. Second, historical return data is available for the LGIP. Third, the average return for the LGIP for the last 8 years has been

similar to the rate earned by non-Pooled districts.

The Pool rate averaged 93 basis points more than the LGIP during 2004. The main reason the Pool return was higher was that it holds securities with longer maturities than the LGIP. By policy, the LGIP operates like a money market fund, and its average duration is usually in the 40 to 50 day range, while the Pool's duration is generally between 0.75 and 1.25 years.



This means that during periods when short-term rates are falling the Pool return should be greater than the LGIP's return. From 2001 through much of 2004, as interest rates remained low, the longer duration of the Pool's investments protected Pool participants from some of the impact of these falling rates.

Since the FOMC started raising rates in June 2004, the gap between the Pool's return and the LGIP's return has narrowed. But adding 93 basis points per year in additional yield would generate about \$9,300 in additional revenue for every \$1 million invested.

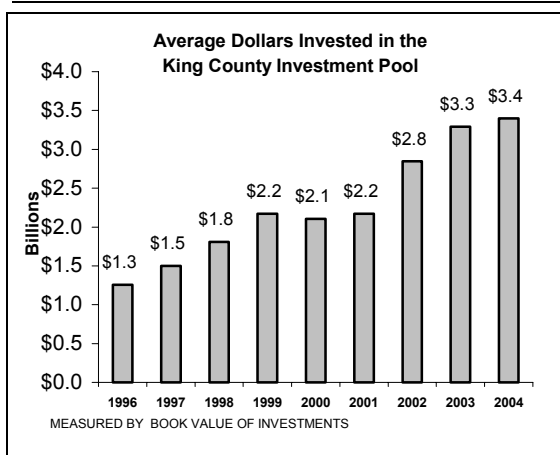
■ Pool Participation

The average amount invested in the Pool reached \$3.4 billion during 2004—an increase of \$100 million over 2003's average. King County was the largest participant in the Pool, holding 44.1% of the Pool's assets. But the junior taxing districts and other public authorities participating in the Pool actually held a majority of the Pool's assets. School districts were the second largest participant at 32.6%, followed by water and sewer districts at 7.9%.

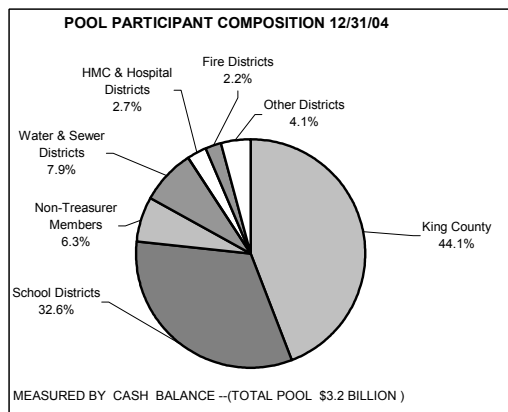


King County Investment Pool

“Not one district has ended participation in the Pool since it was first made available to districts in 1995.”



Two districts joined the Pool during 2004, and there was a merger between two participants. At year-end, there were 97 districts and public authorities participating in the Pool. Not one district has ended participation in the Pool since it was first made available to districts in 1995. We believe this loyalty to the Pool is due to the benefits that the Pool offers.



By participating in the Pool, districts receive a competitive return from a diversified portfolio of high-quality investments. Participating in the Pool also reduces the time that district personnel spend managing investment transactions and planning liquidity needs because their funds are 100% invested, but they still have daily access to their cash when needed. For a list of all districts and public authorities participating in the Pool, please see page 6.

■ Pool Organization

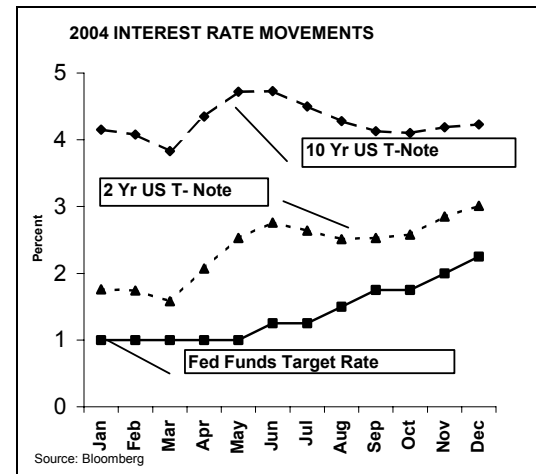
In accordance with Washington State code (RCW 36.48.070), the County's Executive Finance Committee (the EFC) reviews the Pool's investment practices and policies on a regular

basis. The Committee consists of the Chair of the County Council, the County Executive, the Chief Budget Officer, and the Manager of the Finance and Business Operations Division (or their designees). All investment activity is subject to written policies approved by the EFC. The Committee monitors pool performance at its monthly meetings. Responsibility for managing the Pool's investments on a daily basis lies within the Cash Management Unit of the County's Treasury Operations Section.

■ Year 2004: Interest Rate Review

The year began with both short and long-term interest rates at their lowest levels since the 1950s. Weak employment reports in the earlier part of the year pushed 2-year and 10-year yields even lower. The financial markets believed that this weak economic news would keep the FOMC from raising short-term interest rates until later in 2004. The FOMC implements monetary policy for the U.S. Federal Reserve System by setting the federal funds target rate.

The bond market's expectations changed dramatically when average job growth over the months of March, April, and May was over 300,000 jobs, and core inflation showed signs of increasing. Interest rates in the 2-year and 10-year sectors rose significantly once investors realized that an improving economy might force the FOMC to raise rates sooner than expected.



The market's fear of earlier FOMC action was realized when the FOMC voted to tighten monetary policy by increasing their target rate from 1% to 1.25% at its June meeting. This ended the period of keeping interest rates low to stimulate the economy that had begun back in January of 2001.



OVERVIEW OF THE KING COUNTY POOL'S INVESTMENT POLICY				
Investment Types	Max Maturity	Max % Limit	Single Issuer Limit	Minimum Credit Rating
US Treasury	5 Years	100%	None	N/A
Federal Agency	5 Years	50%	50%	N/A
Fed Agency MBS	5 Year WAL	25%	25%	N/A
CD's	5 Years	15%	5%	PDPC ⁽¹⁾
Municipals ⁽²⁾	5 Years	20%	5%	A ⁽³⁾
Bank Notes	5 Years	20%	5%	A ⁽³⁾
Repos	60 Days ⁽⁴⁾	40%	10%	Collateral
Commercial Paper	180 Days	25%	5%	A1/P1 ⁽⁵⁾
BA's	180 Days	25%	5%	Top 50 ⁽⁶⁾
State LGIP ⁽⁷⁾	N/A	None	None	N/A
⁽¹⁾ Institution must be a Washington State depository. Treasurers can deposit up to 100% of bank's net worth. ⁽²⁾ Washington state issuers: general obligations and revenue bonds. Other states: only general obligation bonds. ⁽³⁾ Must be rated "A" or better by two rating agencies. ⁽⁴⁾ 102% collateralized, over 30 days 105% ⁽⁵⁾ Must be rated in top credit category by at least two rating agencies. Maturities > 100 days must have "AA" long-term rating. ⁽⁶⁾ Bankers' acceptances can only be purchased from the 50 largest banks in the world by asset size. ⁽⁷⁾ The state investment pool (LGIP) is a money market-like fund managed by the State Treasurer's Office.				

Usually longer-term rates increase after the FOMC raises short-term rates. The FOMC's assertion that rates could be increased at a "measured" pace helped hold down longer rates. This factor combined with sluggish economic news actually led rates in the 2 and 10-year sectors to fall through August.

However, the summer's weak economic news did not prevent the FOMC from raising the federal funds rate again by 25 basis points, or ¼ of 1%, (100 basis points equals 1%) at its August meeting. The FOMC viewed the summer's less-than-stellar economic news as a temporary soft patch caused by high-energy costs. They believed the underlying economy was improving, and stronger economic reports released later in the year supported their optimism, and they continued to raise rates by 25 basis points at each of the remaining meetings during 2004. The target rate ended the year at 2.25%, or 125 basis points above where it began the year.

The yield on 2-year notes continued to increase in tandem with upward moves in the fed funds target rate, ending the year near 3%, up from 1.8% at the beginning of 2004. The 10-year rate surprisingly fell over the last half of the year, even as shorter-term rates were rising

■ Forecast for 2005 Performance

Economic growth and employment have been improving in the United States while core inflation has remained low. In this environment, it is expected that the FOMC will continue to increase the federal funds target rate during the remainder of 2005 and possibly beyond. In his public statements, the Chairman of the Federal Reserve Board, Alan Greenspan, has stated that the FOMC's goal is to achieve a "neutral" rate—a rate

that neither stimulates nor curtails the economy's growth.

The problem for investors is that Chairman Greenspan will not say exactly where this "neutral" rate lies, but the FOMC has said it will continue to raise rates at a "measured" pace until it reaches this "neutral" rate. The market has interpreted this to mean that the FOMC probably will continue to raise rates in 25 basis point increments at its future meetings. A survey of 66 economists recently taken by Bloomberg News shows that the average forecast for the federal fund target rate at December 31, 2005 is 3.75%. The financial markets are predicting a similar increase; they have priced in a 4% federal funds rate by the end of 2005.

If rates rise as expected, the Pool rate should increase during 2005. The Pool's gross earnings rate has been approximately 2.75% for the first two months of 2005. At this time we are estimating that the average earnings rate for 2005 could be about 3%, and possibly somewhat higher.

■ Review of Pool Investment Practices

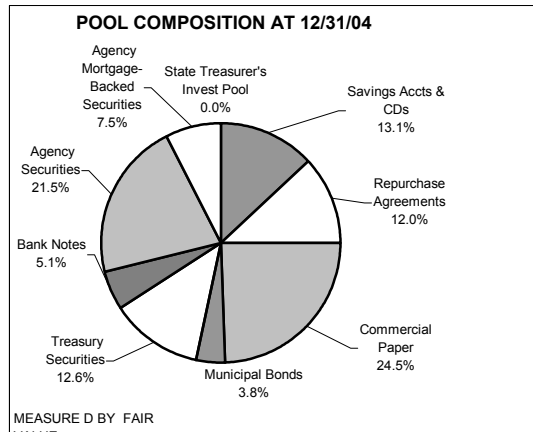
Diversification: The Pool seeks to obtain a market rate of return throughout budgetary and economic cycles while preserving and protecting capital. The Pool pursues its investment objectives by investing in high-quality securities, including U.S. Treasury, U.S. agency notes and mortgage-backed securities, taxable-municipal notes, commercial paper, certificates of deposits (CDs), repurchase agreements, and the LGIP.

The Pool has policies that limit the maximum amount that can be invested in any one of these sectors. The table above summarizes the Pool's diversification policy, while the following pie

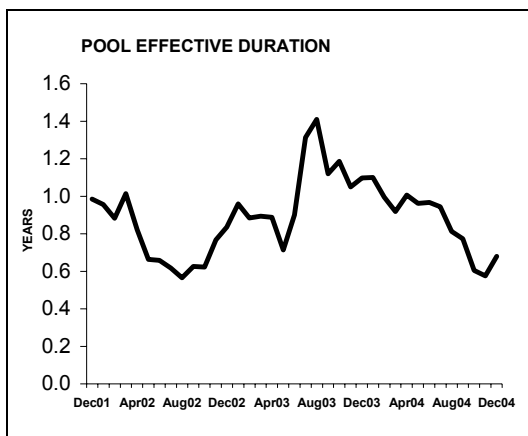


King County Investment Pool

chart shows the Pool's actual composition at year-end.



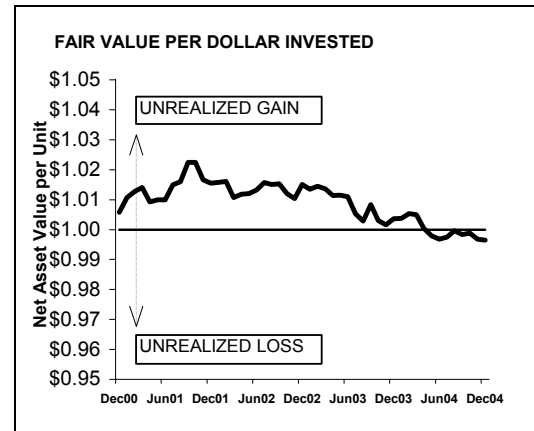
Market Risk: The Pool limits its exposure to changes in interest rates by managing the effective duration of the Pool. Duration is a measure of a portfolio's sensitivity to changes in interest rates. Portfolios with lower durations are less sensitive to changes in interest rates than portfolios with higher durations. For example, if the yield curve instantaneously shifts by 100 basis points the market value of a portfolio with a duration of one year will change by approximately 1%. However, a portfolio with a duration of 10 years would see its market value change by about 10%.



Ideally, the Pool wants to have a longer duration when rates are falling, and a shorter duration when rates are rising. . At year-end the Pool's combined effective duration was 0.7 years. Over the prior eleven years the Pool's duration has averaged 1.1 years and has ranged from 0.6 to 1.8 years.

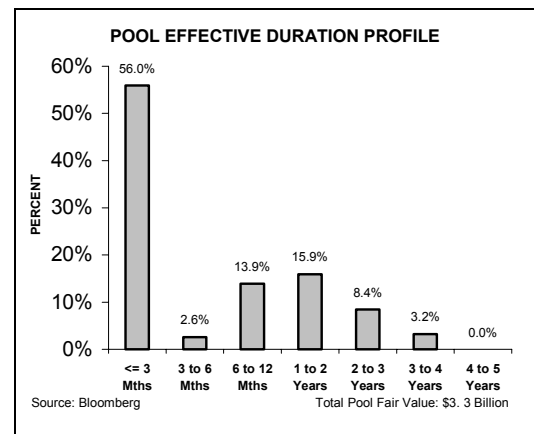
The Pool is managed as two sub-portfolios: the Core portfolio consists of long-term securities, with maturities over one year and the Liquidity portfolio consists of securities with a shorter maturity. The average effective duration of the Core portfolio is limited to a range between 1.25 to 3.25 years. Securities purchased in the Core portfolio must

have a final maturity no longer than five years. The maximum average duration of the Liquidity portfolio is limited to 120 days.



The Pool's duration and maturity policies help to reduce the variation in the Pool's net asset value. At year-end, each \$1 invested in the Pool had a value of \$0.9964. The stability of the Pool's net asset value is demonstrated by the low volatility of the Pool's fair value. Over the last four years the fair value per dollar invested has fluctuated between just \$0.99 and \$1.02.

Although the Pool's fair value is calculated on a monthly basis, unrealized gains and losses are not distributed to participants. The Pool distributes earnings using an amortized cost methodology.



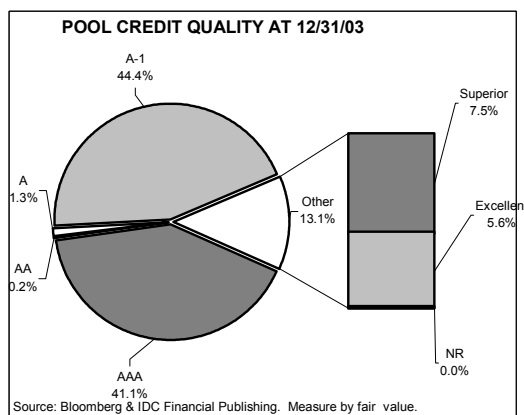
Liquidity: The Pool's policy is to maintain sufficient liquidity to meet all anticipated operating requirements. Historical cash flows are used in combination with projected debt service schedules to insure that the Pool has adequate liquidity to meet all Pool participants' projected needs. At year-end, the Pool had a healthy liquidity position with approximately 56% of the portfolio expected to come due in three months or less.



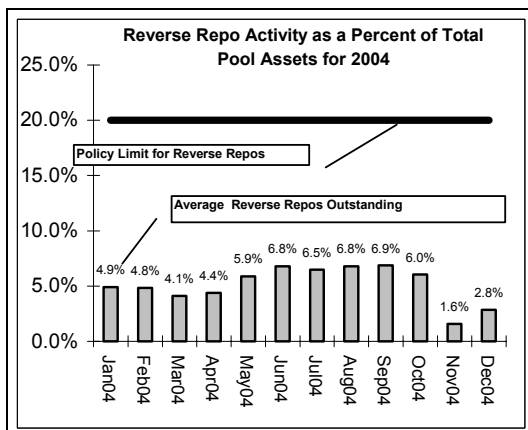
King County Investment Pool

Credit Quality: The Pool has about 41% of its portfolio invested in 'AAA' quality U.S. Treasury, agency, and municipal securities. Almost 44% of the Pool's investments are invested in securities, or placed with counter-parties, that have a short-term rating of at least 'A-1' or its equivalent, which is the top rating for short-term securities.

About 13% percent of the portfolio is not rated by a Nationally Recognized Statistical Rating Organization, or NRSRO, such as S&P. These non-rated investments are composed of CDs and the Pool's investment in the State's LGIP. While this group of investments is not rated by an NRSRO, they are still very safe investments.



CDs are only placed with depositories that are approved by the Public Deposit Protection Commission (PDPC). The PDPC provides security for public treasurers by protecting public deposits that exceed the amount insured by the FDIC. No public funds placed in public depositories have been lost since the Public Deposit Protection Act (RCW 39.58) was created in 1969. As additional protection, the Pool pays for a service provided by IDC Financial Publishing that monitors the financial condition of these non-rated institutions. At year-end the issuers of CDs in the "Other" category were rated either "Excellent" or "Superior" by IDC.

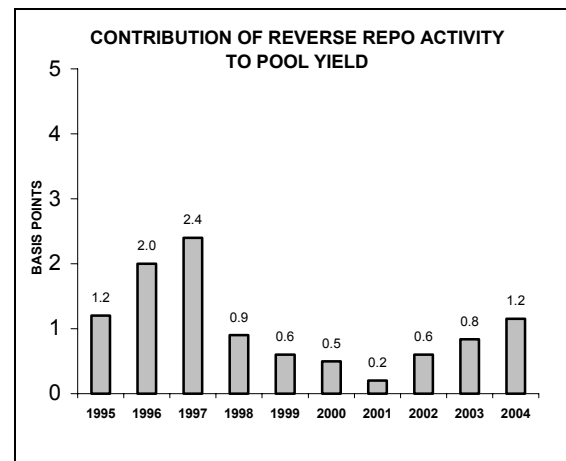


"The Pool generated nearly \$391,000 in additional income in 2004 from reverse repurchase activity."

Leverage: The Pool is authorized to use reverse repurchase agreements. In a reverse repurchase transaction the Pool borrows funds from an approved dealer by pledging securities in its portfolio. It then uses the proceeds of the borrowing to invest in securities that yield more than the borrowing rate. This type of arbitrage transaction generates extra income for the Pool while exposing the Pool to very little risk.

The Pool can only enter into reverse repurchase agreements under the following conservative guidelines:

- No more than 20 percent of the Pool balance may be reversed out at one time.
- The maturity date of the reverse repurchase must equal the maturity date of the investment.
- The maximum allowable maturity is 180 days.
- Reverses will only be entered into with dealers having a master repurchase agreement with King County.



During 2004, total reverse repurchase agreements outstanding at month-end ranged from 1.6% to 6.8% of the portfolio's total assets—never approaching the 20% policy limit. The Pool generated nearly \$391,000 in additional income in 2004 from reverse repurchase activity. This added 1.2 basis points to the Pool's overall yield during 2004. Ω

For further information or questions regarding King County's Investment Pool, please contact the Cash Management Unit at 206-296-7310 or Cash.Management@Metrokc.gov:

Investment Officer: Mike Smith, CFA (Mike.Smith@Metrokc.gov)
Supervisor: Scott Matheson (Scott.Matheson@Metrokc.gov)



KING COUNTY INVESTMENT POOL PARTICIPANTS

<p><u>King County</u> All Agencies</p> <p><u>School Districts</u> Auburn SD No. 408 Bellevue SD No. 405 Enumclaw SD No. 216 Federal Way SD No. 210 Issaquah SD No. 411 Highline SD No. 401 Kent SD No. 415 Lake Washington SD No. 414 Mercer Island SD No. 400 Northshore SD No. 417 Puget Sound ESD No. 121 Riverview SD No. 407 Renton SD No. 403 Seattle SD No. 1 Shoreline SD No. 412 Skykomish SD No. 404 Snoqualmie Valley SD No. 410 Tahoma SD No. 409 Tukwila SD No. 406 Vashon Island SD No. 402</p> <p><i>* Districts joining in 2004</i></p>	<p><u>Fire Districts</u> Black Diamond Fire District No. 17 Burien Fire District No. 2 Eastside Fire & Rescue No. 10 & 110 Federal Way Fire Department No. 39 KC Fire District No. 20 KC Fire District No. 24 KC Fire District No. 25 KC Fire District No. 26 KC Fire District No. 27 KC Fire District No. 28 KC Fire District No. 34 KC Fire District No. 37 KC Fire District No. 40 KC Fire District No. 41 KC Fire District No. 43 KC Fire District No. 45 KC Fire District No. 47 KC Fire District No. 50 Mountain View Fire & Rescue No. 44 North Highline Fire District No. 11 Northshore Fire Department No. 16 Shoreline Fire Department No. 4 Vashon Island Fire & Rescue No. 13 Woodinville Fire Life & Safety No. 36</p>	<p><u>Sewer & Water Districts</u> Bryn Mawr-Lakeridge Sewer District Cedar River District No. 108 Coal Creek Utility Covington Water District No. 105 Highlands Sewer District Highline Water District No. 75 KC Water District No. 1 KC Water District No. 20 KC Water District No. 45 KC Water District No. 49 KC Water District No. 54 KC Water District No. 83 KC Water District No. 90 KC Water District No. 111 KC Water District No. 117 KC Water District No. 119 KC Water District No. 123 KC Water District No. 125 KC Water District No. 127 Lakehaven Utility Midway Sewer District Northeast Sammamish Sewer District Northshore Utilities Sammamish Plateau Sewer District Shoreline Wastewater Mgmt District Shoreline Water District No. 42 Soos Creek Sewer District Southwest Suburban Sewer District Stevens Pass Sewer District Val-View Sewer District Vashon Sewer District Vashon Water District No. 19 Woodinville Water District No. 104</p>	<p><u>Other Districts</u> Cemetery District No. 1 Drainage District No. 1 Finn Hill Park District King County Director's Association King County Law Library King County Library Northshore Parks and Recreation Public Facilities District (Baseball) Puget Sound Air Pollution Control Puget Sound Regional Council Redmond Library Capital Facility Si View Metropolitan Park District Washington State Risk Pool</p> <p><u>HMC & Hospital Districts</u> Harborview Medical Center Snoqualmie Valley Hospital No. 4</p> <p><u>Non-Treasurer Members</u> Evergreen Healthcare (Hospital Dist. 2)* Public Stadium Authority (Football) Puget Sound Regional Transit Authority Water & Sewer Risk Management Pool* Valley Medical (Hospital Dist. 1)</p>
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King County Executive Ron Sims King County Council Chairman Larry Phillips

KING COUNTY EXECUTIVE FINANCE COMMITTEE

Larry Gossett, Councilmember, Chair EFC
Paul Tanaka, County Administrative Officer
Bob Cowan, Finance Director
Steve Call, Budget Director

Committee Staff

Ken Guy, Treasury Operations Manager
Scott Matheson, Cash Management Supervisor
Mike Smith CFA, Investment Officer

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